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American Petroleum Institute Comments on MMS Proposal, "Amendments to Gas Valuation Regulations for Federal Leases." 30 CFR Part 202, 206, and 211; 60 FR 56007 (November 6, 1995) and 61 FR 25421 (May 21, 1996).

Dear Mr. Guzy:

API welcomes this opportunity to submit comments on the MMS' May 21, 1996 proposal and the related options generated at the June 12-14, 1996 meeting of the Federal Gas Valuation Negotiated Rulemaking Committee. These comments augment API's earlier comments filed February 5, 1996.

API's detailed comments are set forth in the attachment which reflects a careful assessment of all of the options now in play in this rulemaking, including many that emerged after the Federal Gas Valuation Negotiated Rulemaking Committee completed its protracted deliberations and after the MMS published its proposal based on the Consensus Rule of the Committee. As our detailed comments state, API should not so casually abandon the carefully negotiated Consensus Rule. If changes are necessary, they should satisfy four criteria: (1) achieving simplification, (2) reducing administrative burden, (3) clarifying valuation standards, and (4) assuring the integrity of the negotiated rulemaking process.

In addition, any rule that API's membership can support must exhibit several features:

First, the royalty valuation point must remain at or near the lease consistent with statutory provisions and lease terms.

Second, an index-based alternative must be preserved, and the methodology must be simple enough to be utilized by all lessees who qualify.

Third, because certain royalty-related issues, such as gross proceeds, affiliated sales, gas contract settlements, and deductible transportation costs are the subjects of legal disputes, rulemaking should not be used to preempt the legal process.

Fourth, for 100% federal and stand-alone leases, takes-based reporting must be allowed. For mixed agreements, a meaningful exception to entitlements must be provided for small producers. This necessitates a reasonable expansion of the qualifications for the exception, as well as an increase in the time period during which a lessee may true up to entitlements.

Fifth, although a true-up of index payments is acceptable as a means of addressing concerns about revenue neutrality and market value, it must be based on the median value of gross proceeds payors. In addition, during the first year, the true-up cannot exceed 105% of the lessee's weighted average index value for a zone.

Sixth, the consensus reached on the treatment of deep water leases must be retained.

Accordingly, API supports the Consensus Rule, MMS Option No. 1 (as modified), or the Unified Industry Proposals No. 1, 2 or 3, each of which adequately addresses the public comments on the Consensus Rule without destroying the original Committee consensus. In addition, API urges the MMS to promulgate a final rule as expeditiously as possible, but notes that in order to comply with the rulemaking notice requirements of the Administrative Procedure Act, only the Consensus Rule or Option No. 1 can be published as a final rule without further notice and comment.

If we can be of further assistance to you in this important rulemaking, please contact me.

Sincerely,

G. William Frick

**Comments of the American Petroleum Institute on the Minerals Management Service's Proposed Amendments to Regulations for Valuation of Natural Gas from Federal Leases for Royalty Purposes**

**30 CFR Parts 202, 206, and 211**
**60 FR 56007 (November 6, 1995); 61 FR 25421 (May 21, 1996).**

The American Petroleum Institute (API) is a trade association whose over 300 member companies represent all aspects of the petroleum industry: exploration, production, transportation, refining and marketing. API's members account for the vast majority of the natural gas produced from federal onshore and offshore leases and the royalties paid on the production and, therefore, have a major stake in the outcome of the present rulemaking.

API has participated actively in this rulemaking. Through its representatives on the Federal Gas Valuation Negotiated Rulemaking Committee (Committee), it has taken a central role in forging the consensus rule published by the MMS at 60 FR 56007 (November 6, 1995). On February 5, 1996 API filed extensive written comments on the November 6, 1995 consensus rule. Moreover, in connection with the MMS' consideration of other options identified at 61 FR 25421 (May 21, 1996) and the June 12-14, 1996 reconvened Committee session, API has worked closely with other industry groups to develop several other options for the MMS' considerations.

## Background

The Consensus Rule adopted by the Committee and published on November 6, 1995 received strong support from producers representing the overwhelming majority of gas produced on federal leases. Nonetheless, on May 21, 1996 the MMS reopened the public comment period and requested written comments on five additional, MMS-devised options for its gas valuation rulemaking.

This Consensus Rule was the consensus recommendation of the Committee. The Committee (consisting of representatives of a broad spectrum of the natural gas industry, MMS staff, and auditors from certain states in which Federal gas leases are located) was originally formed in December, 1993, as an informal group to study the benchmark system and later expanded its scope to include valuation of Federal gas production under arm's-length contracts. In June, 1994, the informal study group was convened at the direction of the Secretary of Interior as the Federal Gas Valuation Negotiated Rulemaking Committee to continue to respond to widespread disagreement over the MMS' current gross proceeds and benchmarking valuation standards, and to a perceived need to clarify those standards and end confusion over their application. These standards have become increasingly unworkable for many producers marketing gas in the post Federal Energy Regulatory Commission (FERC) Order No. 636 marketplace, and difficult for MMS auditors to apply. Members of the Committee worked steadily for 14 months to prepare the

Consensus Rule. Many hours and travel budget dollars were spent in the Committee's effort to study, develop and negotiate a workable alternative to the gross proceeds and benchmarking valuation standards. This alternative would allow valuation based upon publicly available published market prices, i.e., Index Pricing.

Although the vast majority of significant federal royalty payors expressed support for the Consensus Rule, either through their company specific written comments or through their trade association comments, a few concerns were expressed in filed comments. The MMS apparently attached great weight to some of these criticisms, because it devised five new options, four of which radically departed from the Consensus Rule, asserting that they were in response to "substantial" adverse comments. Inexplicably, however, these options notably failed to address many of the concerns raised by those small independent producers who filed the majority of the adverse comments. Seemingly, the MMS gave very modest weight to small producer concerns, and no weight to the views of the many who favored the Consensus Rule. MMS attached inordinate weight to the comments of two states, only one of which, Colorado, has substantial quantities of federal gas affected by the Consensus Rule. The other, Montana, would not likely be affected by the Consensus Rule to any significant degree at all because there is no Index price applicable to Montana production. Therefore, Montana production would likely be valued on the current gross proceeds basis.

In addition to reopening the record for public comment in this proceeding, MMS reconvened the Committee in Denver from June 12 - 14, 1996. The Committee members in that session commented upon the MMS' specific five alternative options, and a few additional options were developed. Of particular note, the entire natural gas industry, from major integrated producers to small, medium and large independents alike, united behind certain proposed alternatives. For the purpose of these comments, these alternatives will be referenced as the Unified Industry Proposals. These Unified Industry Proposals satisfactorily address those problems with the Consensus Rule which were publicly articulated in the filed written comments, including those independent producer concerns which were not addressed by the MMS's Five Options.

**Summary of the API Position**

In its February 5, 1996 comments, API supported the November 6, 1995, Consensus Rule. And while many aspects of the Consensus Rule are unfavorable and objectionable in isolation, API supported the overall package because it was a negotiated compromise. It would severely compromise the utility of negotiated rulemaking as a workable procedural tool if every party who participated in the negotiation of a proposed rule attacked the resulting compromise rule because not every point was negotiated in the party's favor. After encouraging parties to embark on a negotiated rulemaking process, MMS should adhere as closely as possible to the Consensus Rule end-product in its Final Rule so as not to jeopardize the viability of this procedural rulemaking tool for the future. MMS has a responsibility to all federal agencies to ensure the integrity and

credibility of the negotiated rulemaking process and substantial deviation from the Consensus Rule would undercut public trust in the process.

Nonetheless, API understands that the negotiated rulemaking process is not a substitute for the informal rulemaking process and that MMS may modify the Consensus Rule to address comments received during the notice-and-comment period. Even if changes are made, however, API urges MMS to proceed expeditiously to a final gas valuation rule which adopts a viable, workable Index-price based valuation alternative, and which adopts as much as possible of the Consensus Rule. Industry, states and MMS have devoted far too much time and effort over the past two years in the negotiated rulemaking process to have the culminating consensus product of this effort lightly cast aside. Industry groups would be understandably reluctant to commit to future negotiated rulemaking exercises with this or any other federal agency, if the work effort, in the end, is substantially rejected.

In fashioning a final rule, the MMS should also bear in mind the shared goals of industry, the states and MMS. The MMS, states and industry have been searching for (a) simplification, (b) reduction in administrative burden and (c) clarity in valuation. Clarity alone would avoid a quagmire of legal disputes over what components, if any, of downstream revenue constitute market value at the wellhead, and disputes over access to the data of lessees' marketing affiliates. These goals can be achieved if MMS can move to a workable Index price valuation system, and away from spending government and industry's audit and accounting time and resources attempting to trace and allocate value from increasingly complex post- FERC Order No. 636 transactions.

Any changes to the Consensus Rule should, therefore, be measured against four touchstones: (1) achieving simplification, (2) reducing administrative burden, (3) clarifying valuation standards, and (4) insuring the integrity of the negotiated rulemaking process. If changes to the Consensus Rule must be entertained, API supports proceeding either on the basis of: (a) any of the Unified Industry Proposals because all segments of industry solidly support them, they meaningfully address all of the adverse criticism articulated in public written comments, and they compare favorably to most other options when measured against the four touchstones; or (b) MMS Option 1 (with the caveats expressed below) because it is closest to the Consensus Rule. As measured against the four above-mentioned touchstones, MMS Options 2 through 5, and all of the options developed by the states and MMS at the reconvened Committee Session, fail and should be discarded. None present a useful basis for a workable valuation system.

API further notes the Consensus Rule provides for a delayed implementation date, making the Index valuation system effective on the first January 1 occurring after six months following the adoption of a Final Rule. Given the need for expeditious implementation of Index valuation, API urges the MMS to change this provision to allow for earlier implementation on the first day of the month occurring six months after the Final Rule is adopted. Companies may need six months of

lead time to convert their accounting systems to the new valuation requirements, but there is no need to delay implementation for yet another calendar year.

**Comments on the Five MMS Options published in the at 60 FR 25421 (May 21, 1996)**

**Option No. 1**

Because it most closely tracks the Consensus Rule, Option No. 1 is the most viable of the five MMS options for a final rule, subject to the revisions suggested below.

The MMS' Point One proposes to state the final rule in "plain English". This apparently reflects MMS's obligation to utilize second person, active voice, bullets and sub-titles, etc., in writing new regulations. Point One was supported by the Committee at the June 12-14 meeting. While API's member companies agree with the concept of drafting rules in "plain English," there is concern that MMS's attempt to comply with "plain English" requirements may result in unintended substantive changes to existing regulations. Specifically, in the Consensus Rule, 30 CFR parts 202 and 206 were restructured in order that Indian leases would not be affected, and in order to retain most of the existing regulations applicable to Federal gas while adding the proposed alternative valuation method. If MMS must now rewrite in "plain English" those portions of parts 202 and 206 that were never intended to be altered, great care must be taken not to make substantive changes. Thus, any redrafting of existing regulations in "plain English" should be accompanied by a clear expression of the lack of intent to make substantive changes. It should also be accompanied by language similar to that which appeared at 60 FR 56007, which acknowledged that incorporation of the Committee's consensus into the existing regulatory framework should not be interpreted or infer that consensus was reached on longstanding differences of opinion with MMS on the meaning and interpretation of existing regulations, or that said differences of opinion had been waived or withdrawn.

In Point Two, MMS proposes to adopt "minor technical and procedural improvements" suggested in the public comments. It remains unclear which of the suggested changes MMS considers to be "minor procedural and technical improvements that would not modify the consensus of the Committee." API cannot support the inclusion of these "improvements" in a final rule until its members have had an opportunity to review and evaluate them.

In Point Three, MMS proposes deleting the second sentence of proposed 30 CFR 202.450(b) which would deny the royalty-free use of gas downstream of the FMP. Such a provision was not part of the original Committee consensus, and was apparently included in the proposed rule by mistake. API's member companies support this change. Deletion of this language was also agreed upon by all at the June 12-14 meeting. *Minutes, June 12-14, 1996*, at 21.

In Point Four, MMS would include a provision for takes-based reporting for 100 percent Federal agreements and stand-alone leases. API's members support this concept, but urge that MMS include an exception to pay on other methods as specified in the original "MMS Proposal on Takes" endorsed by the Committee. This concept was also unanimously supported at the June 12-14 Committee meeting. *Id.*

In Point Five, MMS would grant an additional six months beyond the two-year period provided in the Committee consensus in which to calculate and publish the safety net median value for each zone. API opposes this provision, because the two-year audit period was the result of considerable debate and negotiation during the original deliberations of the Committee. The *Minutes* of the August 24-25, and September 12-13, 1994, meetings reflect that industry representatives were concerned with achieving certainty of royalty valuation as soon as possible and therefore advocated a one-year period during which the majority of retroactive adjustments would occur. MMS and the states had concerns about "misreporting" on 2014's and capturing additional value resulting from audits, AFS/PAAS exceptions, and appealed orders to pay. Industry reluctantly agreed to the two-year period, but only upon having received assurances from MMS, including the Deputy Associate Director for Compliance, that necessary audits, processing of appeals, and calculation of the safety net median value could be accomplished "within 2 years after the index year." *Final Report*, at 43 (emphasis supplied). Having taken such pains during the negotiations to assure industry that the safety net calculation could be accomplished within two years, it is unfair for MMS to now assert that an additional 6 months is necessary. API's members urge MMS to honor its commitment to publish the safety net within two years. The result of MMS's failure to do so should be that no additional royalty would be due. At the June 12-14 Committee meeting, state representatives concurred that no additional royalty should be due, but advocated that states should be "kept whole" when the calculation was finally made. ("If no safety net in 2 years, and no money from industry; then credit against receipt sharing." *Minutes, June 12-14, 1996*, at 3.)

MMS has suggested that timely publication of the safety net median value may be delayed in the event of future government shut-downs or furloughs. API's members could support a narrowly applied exception that would, upon notice in the *Federal Register*, provide for additional time to publish the safety net median value, together with the suspension of the accrual of late payment interest, in the event of a governmental *force majeure*, as specifically defined. However, as presently worded, Point Five is overly broad and would allow MMS unlimited discretion to extend the two-year period up to six months. At a maximum, the two-year period should be extended only by a length of time commensurate with the time period associated with the governmental *force majeure*.

In Point Six, the MMS "would require index-based payors to pay royalty on contract settlement proceeds received from settlements entered into after the effective date of the rule." 61 FR 25424. API's members cannot support this broadly worded provision for numerous reasons:

- *First*, whether contract settlement proceeds are royalty bearing is an issue which is the subject of pending litigation. In the event that certain contract settlement proceeds are held by the courts not to be royalty-bearing, Point Six, as presently worded, appears to be an attempt to circumvent such a holding. If that is MMS's intent, API's members oppose it.

- *Second*, with respect to contract settlements entered into prior to the effective date of the final rule, the Consensus Rule, at 30 CFR 206.454(a)(6), would require royalty only if the Department's position is ultimately upheld. "If the lessee receives or received any revenue in connection with reformation or termination of any gas purchase contract that occurred prior to effective date of this rule ... those revenues may be subject to royalty in accordance with the Department's existing precedents at the time a part of such revenue is attributed to later production. If so, royalty will be due on the increment of revenue attributed to future production in addition to any index-based or other value established under this section . . . ." 60 FR 56024 (emphasis supplied). Thus, Point Six is inconsistent with proposed §206.454(a)(6).

- *Third*, revenues received by index payors from settlements entered into after the effective date of the final rule should not be subject to additional royalty, because such revenue, if paid voluntarily by the purchaser under the contract (rather than pursuant to the settlement of a contract dispute) would not be subject to royalty under the proposed rule.

- In any event, during the original Committee deliberations, it was agreed, as a result of well documented discussion and negotiation, that royalties on pipeline buyout and buydown settlement proceeds should not be included in the safety net calculation. This concept was also agreed upon at the June 12-14 Committee meeting. *Minutes, June 12-14, 1996*, at 21. Assuming *arguendo* that royalties are due on contract settlement proceeds, the final rule should require that such royalties be reported separately from regular royalty payments in order that they can be excluded from the safety net calculation.

Point Seven is acceptable, provided that the credit can be effectuated by means of recoupment, credit, offset, or refund, and be based on the actual value upon which royalties were overpaid. During discussion of this issue at the June 12-14 meeting, state representatives stated this was a minor issue and that a credit based on the actual value was acceptable. *Minutes, June 12-14, 1996*, at 3. This area of agreement was inadvertently omitted from the "What We Agree On" list generated on June 14. MMS specifically requested comments on how this credit should be processed. 60 FR 56014. MMS should ensure that the final rule reflects the agreement by all parties that this credit should be based on the actual value upon which royalties were paid.

Point Eight, concerning issuance of separate guidance on the reporting of gas valuation methods, is acceptable. Point Eight was endorsed by all at the June 12-14 Committee meeting.

Point Nine, under which MMS would publish a separate rulemaking on benchmark valuation, is acceptable. Point Nine was also considered acceptable by the state representatives at the June 12-14 Committee meeting. In drafting new benchmarks, however, MMS should consider not only comments on the November 6, 1995, proposed rule, but also the discussion which took place during the original deliberations of the Committee. This discussion is described in detail in the *Minutes* and in the *Final Report*. ("MMS will write a proposed rule that will consider the comments and suggestions made by the committee." *Minutes, January 30-February 3, 1995*, at 19).

**Option No. 2**

Under this option, MMS proposes to replace the MMS-calculated safety net median value with a safety net value calculated by the index payor based on its own arm's-length sales, including sales by an affiliate. Within a certain tolerance, no royalty adjustments would be required. However, if the difference between the lessee's weighted average index payments and its weighted average pool price exceeded the tolerance, royalty adjustments would be required, resulting either in additional royalty due or a refund. This self-implementing safety net calculation would be subject to future audit. API's members strongly object to Option 2 on the following grounds:

- *First*, the safety net calculation was one of the most extensively negotiated features of the regulatory negotiation. Industry representatives initially opposed a safety net calculation, maintaining that indexes, net of transportation costs, reflected the market value of production at the lease more effectively than any other measure of royalty value. Industry accepted the safety net, only reluctantly, in response to MMS and state concerns about revenue neutrality. ("In essence, the safety net provided MMS and the states assurance that index-based values would not result in substantially lower revenues than those received under gross proceeds while allowing industry the option to report and pay on index. The safety net helped to alleviate some of MMS's concerns regarding revenue neutrality associated with an index-based method." *Final Report*, at 41). A safety net calculation based on the index payor's weighted average pool price, *i.e.*, Option No. 2, was proposed on numerous occasions and discussed at length. *Minutes, August 24-25, 1994*, pp. 3-12. Ultimately, however, the concept was abandoned in favor of a calculation based on MMS-2014 information reported by gross proceeds payors. *Minutes, August 24-25, 1994,* pp. 13-15; *Minutes, September 12-13, 1994.* Therefore, Option No. 2, is merely a reiteration of an alternative that was considered earlier and rejected. In order to implement Option No. 2 in a final rule, MMS would have to disregard the deliberations of the Committee and repudiate its own assurances that the calculation could be performed by MMS.

- *Second*, under Option No. 2, index-based payments would only be estimated payments which would subsequently be adjusted to gross proceeds. Lessees would be required to trace production through pools consisting of hundreds of downstream sales and transportation contracts, and the resulting weighted average price would be affected during the annual period

by thousands of retroactive adjustments. Since actual tracing would be impossible, various assumptions, allocations and extrapolations would have to be made. Auditing the pool price would be virtually impossible, necessitating the review of hundreds of transactions plus adjustments. Even worse, disputes over gross proceeds, allowable deductions, affiliate resale information, and any assumptions, allocations and extrapolations would arise. In short, the very problem which gave rise to the need for index pricing would become part of the index pricing alternative. Moreover in establishing royalty value based on indexes and proceeds, Option No. 2 would require lessees to perform dual accounting. Thus, all of the benefits of the alternative valuation methodology of the Consensus Rule would be lost. Moreover, any anticipated reduction in MMS's administrative burden resulting from shifting the safety net calculation to index payors would be more than offset by the administrative burden of verifying lessees' safety net calculations.

**Option No. 3**

Option No. 3 is an attempt by MMS to address concerns expressed by only 3 of 44 commenters, STRAC, Colorado, and Montana.[1] Because many of these concepts were discussed and ultimately rejected by the Committee, API's members oppose this Option.[2]

Point One would require index applied to the wellhead MMBtu, eliminate the option to pay index on residue only and gross proceeds on liquids, and eliminate wellhead MMBtu reporting based on the gross proceeds residue gas price. API's members can accept elimination of the option to value residue on index and liquids on gross proceeds, provided that appropriate transportation allowances are retained. However, the option to value processed gas based on the gross proceeds residue gas price applied to the wellhead MMBtu should not be eliminated for gross proceeds payors.

- *First*, wellhead MMBtu reporting was negotiated as part of a single package for both index payors and gross proceeds payors. During these discussions, industry representatives made significant concessions in order to accommodate various MMS and state concerns, including: (1) abandoning two separate safety nets for processed and unprocessed gas in favor of a single safety net containing unprocessed gas, processed gas, and NGL's; (2) increasing the true-up percentage in recognition that there may sometimes be uplift due to processing and perceived difficulties in auditing gas plants; and (3) abandoning various options, including residue on gross proceeds and NGL's on index. ("Using the objectives of simplicity, fairness, and reduced administrative cost, the committee agreed that there should be only one safety net

[1]Inasmuch as none of the small volume of Federal gas produced in Montana would be eligible, under the Consensus Rule, for valuation using an index-based methodology, Montana is not actually affected by the index, safety net, safety net caps, or any other aspects of the alternative valuation provisions of this rule and its comments deserve little weight in making a change.

[2]Even the states expressed objections to certain aspects of this option at the June 12-14, Committee meeting. *Minutes, June 12-14, 1996*, at pp. 5-6.

calculation. In addition, the committee agreed that gross proceeds lessees should have the option to value their processed gas on a wellhead MMBtu basis. However, in order to limit lessees' options, the committee agreed that gross proceeds-based lessees must remain on a gross proceeds valuation basis." *Final Report*, at 62.) In view of the concessions industry made in order to gain the administrative ease of wellhead MMBtu reporting, it would be grossly unfair if this option were eliminated for gross proceeds payors.

- *Second*, wellhead MMBtu reporting for processed gas would significantly reduce the administrative burden both for gross proceeds payors and MMS. A valuation methodology which would permit only index payors the benefit of simplified reporting would discriminate against gross proceeds payors. Such discrimination is unacceptable to industry, and would also appear to be inconsistent with views expressed by the states, who opposed options that might favor index payors and discriminate against gross proceeds payors. ("The STRAC recommends that MMS make an in-depth review of all the options and elections to ensure that they are justified for all, equal to all . . . ." *Comments of the State and Tribal Royalty Audit Committee, February 5, 1996*, at 7, incorporated by reference by Montana in its comments [emphasis supplied]. "[T]he proposed rule discriminates against gross proceeds payors." *Comments of the Board of Land Commissioners, State of Colorado, February 2, 1996*, at 2.) Yet Point One would deny gross proceeds payors, and MMS, the benefit of simplified processed gas reporting. Contrary to STRAC's assertion, it is the elimination of the option, rather than retaining it, which would result in discrimination.

Point Two would remove the safety net caps. The state commenters maintain that elimination of the caps is justified on the grounds that: (1) caps limit true-up to market value, and (2) caps result in a double adjustment inasmuch as the median value on the safety net calculation protects index payors from pricing anomalies contained in the gross proceeds-based MMS-2014's. *Comments of State and Tribal Royalty Audit Committee, February 5, 1996*, at 3. On the contrary, caps do not limit true-up to market value; they limit true-up to proceeds. During the Committee deliberations, industry representatives maintained that market value at the lease was better approximated by index, net of transportation, than by proceeds from hundreds of remote sales artificially allocated back to the lease. Because the Committee members disagreed on which of the two best represented market value, the safety net cap was negotiated in order to recognize a middle ground between two opposing views of market value. The cap was also necessitated because MMS and the states insisted on collecting interest on true-up payments, and because no downward adjustments would be allowed in the event index payments exceeded the safety net. *Final Report*, at 42. "The concept of a cap on the safety net calculation was developed by the committee for several reasons, which included: 1) the risk of litigation by both parties would be split equally, 2) disputes regarding Order No. 636 components in gross proceeds valuation, and 3) if no cap, index valuation would be equivalent to gross proceeds." *Id.* (emphasis supplied). Thus, the cap is not a double adjustment to value and it should not be discarded. It was never intended to address pricing anomalies. Rather, it was negotiated in recognition of disputes concerning market value, late payment interest on true-up payments, and the "higher of" valuation requirement placed on

index payors. Industry was forced to make significant concessions with respect to these disputes. Therefore, removing the safety net caps without reciprocal concessions to industry would be grossly unfair.

Point Three would retain the weighted average method but eliminate the "fixed index" method for determining the index pricing point (IPP). However, a "weighted average only" method was discussed and rejected. During the Committee deliberations, industry representatives advocated, for the sake of simplicity, an arithmetic average of IPP's based on physical connection rather than actual flow. Concerned about disparate markets and "no flow' situations, MMS and the states supported either a weighted average based on actual flow or the highest IPP. Industry maintained that weight averaging IPP's based on physical flow would require tracing and would therefore be overly complex and burdensome; further, for gas sold at or before reaching a split or multiple connect, industry maintained that weight-averaging would be impossible. Industry opposed using the highest IPP because higher priced markets were often constrained or merely anomalous. In the end, in order to get a method that would allow the selection of a single IPP rather than a weighted average of numerous IPP's based on tracing, industry conceded to an election of weighted average or the fixed index method. "[T]he states, industry, and MMS compromised by allowing lessees to elect between two options . . . for a period of two years. The committee believed that using the highest or second highest IPP was the best way to achieve simplicity and at the same time ensure a sufficient value for royalty. In other words, paying at a higher price index was a cost of simplicity." *Final Report* at 23 (emphasis supplied). Therefore, eliminating this option will actually increase complexity. API opposes Point Three unless adjustments to the methodology are made to accommodate industry's need for a simple alternative to determine the IPP.

Point Four would change the safety net from a median value to the weighted average of all arm's-length gross proceeds in the zone. Such a change would be unacceptable to API's members. During the original deliberations, this alternative was discussed and ultimately rejected in favor of a median value on the grounds that a weighted average calculation could easily be skewed if there were a disproportionate number of sales at above-market, or below-market, prices. A median value calculation similar to major portion analysis was considered a more reliable indicator. "[T]he committee agreed to use the median value method currently used for determining major portion for Indian gas. This median value method was chosen primarily to eliminate the effect of pricing anomalies in the gross proceeds reported to MMS." *Final Report*, at 42.

Point Five would provide for transportation allowance deductions consistent with determining the IPP using the weighted-average method set forth in Point Three. As general matter, it is recognized that the transportation allowance should be consistent with the selected IPP. However, because API's members strongly oppose the elimination of the fixed index method without replacing it with another simple method that would avoid tracing (e.g., arithmetic average), Point Five is unacceptable. Further, because a simplified IPP selection method will inevitably include "no flow" situations, transportation allowances cannot be limited to the actual rate paid. The

maximum IT rate should be allowed in "no flow" situations. Lessees should be allowed to deduct a *de minimis* rate.

In Point Six, MMS proposes to distinguish between transportation and gathering at the facility measurement point (FMP). API's members oppose Point Six. The definitions of transportation and gathering recommended by the Committee resulted from extensive discussion and negotiation. In acquiescing to the "identifiable/measurable production" distinction, (an approach conceptualized and advocated by MMS), industry conceded, for the sake of compromise, its position that the distinction should be based on the function of the line. The record clearly indicates that a "bright line" test at the FMP was considered and rejected by the Committee, most notably because such a test would be particularly inappropriate in offshore situations, where the FMP may be located a great distance from the lease. ("The facility measurement point should not determine transportation or gathering." *Minutes, March 21-23, 1994,* at 7.) Further, in order to address concerns about revenue neutrality, the existing 50% limitation on transportation allowances was retained. *Final Report*, at 72. In any event, Point Six was rejected by all at the June 12-14 Committee meeting, and the distinction contained in the Consensus Rule was included on the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 21.

**Option No. 4**

Point One, which would provide for a self-implementing safety net based on the lessee's own gross proceeds or affiliate resale proceeds, is identical to Option No. 2, discussed *supra*, and API's objections are reiterated here.

Point Two is almost identical to Option No. 3, Point 2, except that gross proceeds payors would retain the option to apply a gross proceeds-based residue value to the wellhead MMBtu with a self-implementing safety net based on their own residue and NGL gross proceeds. As previously stated, API's members can accept the elimination of the option to pay index on residue and gross proceeds on NGL's. Further, while API supports retaining the option of gross proceeds payors to apply a gross proceeds residue price to the wellhead MMBtu, its members oppose the self-implementing safety net calculation because it effectively requires dual accounting by the lessee.

Point Three would determine the IPP using the closest index pricing point to which the gas physically flows. This is appropriate for single connects, and would also be possible for multiple connects. However, during the original deliberations, the Committee concluded that for split connects (often market centers) there is no "closest" IPP. API's members therefore oppose Point Three.

Point Four would provide for transportation allowance deductions consistent with the closest IPP, as set forth in Point Three. As a general matter, the transportation allowance should be consistent with the selected IPP. However, using the closest IPP is unworkable for split connects. Therefore, Point Four is unacceptable to API's members. As stated above, API's members could

support either the Consensus Rule or, for the sake of simplicity, an arithmetic average of IPP's for split and multiple connects, and the determination of transportation allowances consistent with the IPP selection method. Because a simplified IPP selection method will inevitably include "no flow" situations, transportation allowances cannot be limited to the actual rate paid. The maximum IT rate should be allowed in "no flow' situations. Lessees should be allowed to deduct a *de minimis* rate.

Point Five is identical to Point Six of Option No. 3, discussed above, and API's objections are reiterated here.

**Option No. 5**

Under this option, the alternative valuation options recommended by the Committee would not be implemented. API strongly opposes this option, as a whole, because it departs the most from the consensus of the Committee, and because implementation of this option would repudiate two years of effort by the Committee and frustrate the negotiated rulemaking process.

In Point One, MMS proposes that the current gross proceeds-based valuation regulations be maintained, and that the valuation benchmarks for non-arm's-length sales set forth at 30 CFR 206.152(c) and 206.153(c) (1995) be modified as set forth at 61 FR 25424-25425. API's member companies strenuously object to the benchmarks set forth in Point One for many reasons articulated by industry representatives when the same proposal was made by MMS and the States during the January 30-February 3, 1995, Committee meeting. In addition, Point One, considered to be more objectionable than the existing benchmarks, is unacceptable for the following reasons:

- *First,* MMS's legal right to determine royalty value based on the first arm's-length sale by a lessee's affiliate has never been established, and is certainly contested by API's member companies. Although MMS has long required that the minimum value for royalty purposes be the gross proceeds accruing to the lessee from the sale of gas, the term "lessee" is defined by statute and by regulation as "any person to whom the United States, an Indian tribe, or an Indian allottee, issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease." 30 USC 1702(7); 30 CFR 206.151. "The term 'lessee' is specific and cannot be expanded to include an affiliate of the lessee." *Shell Oil Co. (On Reconsideration),* 132 IBLA 354, 357 (May 11, 1995) Thus, MMS has no authority to deem the proceeds received by a lessee's affiliate to be the gross proceeds accruing to the lessee from the sale of gas. Yet MMS would establish as the second benchmark the first bona-fide arm's-length sale by the affiliate. 61 FR 25425. API's members urge MMS not to do so.

- *Second,* MMS has interpreted its own regulations to require determination of royalty value based on an affiliate's resale proceeds in only two specific situations: (1) resale by the affiliate in the same field as the first sale from the lessee to the affiliate (*Policy Paper: Valuation of Sales to Affiliates* [October 14, 1993]) and (2) resale by a "marketing affiliate," *i.e.,* an affiliate

of the lessee whose function is to acquire only the lessee's production and to market that production (30 CFR 206.151). In proposing a valuation scheme that would require greater dependence on an affiliate's resale proceeds, MMS appears to be shifting the royalty valuation point farther downstream from the lease. Yet at the same time, it steadfastly refuses to share in the considerable risk and expense associated with participation in these new downstream gas markets. MMS's movement away from compromise on this issue conflicts with its duty under the *Negotiated Rulemaking Act* to "negotiate in good faith to reach a consensus on the proposed rule." 5 USC 583.

- *Third*, calculating royalty value based on an affiliate's resale proceeds would place an enormous administrative burden on lessees, who would be required to trace gas downstream through hundreds of separate sales and recalculate royalty value each time retroactive adjustments were recorded for each downstream disposition. Such royalty calculations would be virtually impossible to verify upon audit. These problems, all described in great detail in the original Committee deliberations, would be much worse in instances where the lessee owned a minority interest in an affiliated company, joint venture, alliance, or co-op, and was dependent on another entity for information necessary to calculate royalty value. In addition, disputes about what revenues are part of gross proceeds and what costs are deductible in a post-FERC 636 environment would arise in virtually every instance.

- *Fourth*, although the Committee failed to reach consensus on improved valuation benchmarks, the enormous advantage of the Consensus Rule was that it eliminated the need for the valuation benchmarks in most instances. "The majority of the problems associated with the current benchmark system have been solved through the committee's development of the index method and the associated safety net . . . . [A]t least 95 percent of all Federal gas is produced in zones where, under the committee recommendation, non-arm's-length production must be valued on the index method." *Final Report*, at 53. One result of discarding the alternative valuation options of the Consensus rule would be that <u>all</u> non-arm's-length transactions would continue to be valued under the benchmarks. The enormous benefits realized by the Consensus rule would be lost, and the likelihood of valuation disputes and legal challenges would therefore increase.

- *Fifth*, in proposing the benchmarks set forth in Point One, MMS has failed to consider the discussion which took place during the original deliberations of the Committee. This discussion is described in detail in the Minutes of the January 30-February 3, 1995, meeting. MMS has also disregarded the "Industry Proposal" appearing at pp. 54-55 of the *Final Report.* "The committee did not reach consensus on the issue of improved benchmarks. MMS will write a proposed rule that will consider the comments and suggestions made by the committee." *Minutes, January 30-February 3, 1995*, at 19. MMS should honor its commitment to consider the comments and suggestions made by the Committee. It is encouraged to fashion new benchmarks in such a manner as to (1) establish royalty value based on arm's-length sales occurring at or near the lease, (2) avert legal disputes over gross

proceeds, FERC 636 transportation, and affiliated sales, and (3) avoid impracticable, overly complex netbacks from untraceable downstream sales occurring at multitudinous locations far from the field or lease.

In Point Two, MMS would adopt the Committee's recommendation for entitlements-based reporting, but with no exception for small producers, allowing MMS-approved exceptions only under limited circumstances. API's members oppose this proposal because it fails to provide a meaningful exception to entitlements, an objection which appeared frequently in the public comments submitted on the November 6, 1995, proposed rule. The need for a meaningful and practical exception to entitlements reporting for mixed agreements was also agreed upon by all at the June 12-14 Committee meeting and was included on the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 21.

In Point Three, MMS proposes inclusion of a provision for takes-based reporting for 100 percent Federal leases and stand-alone leases. API's members support this concept, but urge that MMS include an exception to pay on other methods as specified in the original "MMS Proposal on Takes" endorsed by the Committee. This concept was also unanimously supported at the June 12-14 Committee meeting and is included on the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 21.

Point Four is identical to Point Six of Option No. 3, discussed *supra*, and API's objections are reiterated here.

**Comments on Additional Proposals at the June 12-14, 1996 Committee Meeting**

At the June 12-14, 1996, Committee meeting, several other proposals were introduced. These proposals are underlined below.

**New Mexico Proposal**

1. For split/multiple connects, determine the IPP using the weighted average method. This is identical to Option No. 3, Point 3, discussed *supra,* and API's objections are reiterated here. As stated before, eliminating the simplification options in favor of a weighted average based on actual flow would increase complexity.
2. Determine the location differential/transportation allowance based on weighted average and actual flow. The location differential would equal lessee's actual costs to IPP. In No Flow situations, index would be applied at the wellhead with no location differential. For non-arm's-length/non-jurisdictional transportation, the allowance would equal lessee's actual cost, or the *de minimis* rate with MMS approval. As stated in Option No. 3, Point Five, *supra*, determining the IPP and location differential based on weighted average and actual flow requires tracing and would be overly complex and burdensome. API's prior objections to Option No. 3, Point Five, are reiterated here. As a general matter, API's members strongly

oppose, and dispute the legality of, any method which would attempt to establish value for royalty purposes based upon prices at sales points remote from the lease without providing for a transportation allowance. Further, requiring prior MMS approval in order to deduct a *de minimis* rate would only increase complexity and the lessee's and lessor's administrative burden while providing no additional benefit, since the *de minimis* rate is a minimal MMS-calculated rate.

3. Delete options for index payors to pay index on a wellhead MMBtu, and for gross proceeds payors to pay the gross proceeds residue price, on a wellhead MMBtu. Retain 50% safety net cap. API's members strongly oppose this proposal. In order to gain the administrative ease of wellhead MMBtu reporting, industry made significant concessions to accommodate MMS and state concerns about revenue neutrality, possible uplift due to processing, and excessive options. See, *Final Report*, at 62; Minutes, *January 30-February 3, 1995*. In addition, elimination of wellhead MMBtu reporting from the alternative methodology would increase complexity, not simplicity.
4. Delete deepwater exceptions. API's members strongly oppose this suggestion on numerous grounds. *First*, neither New Mexico, nor any other state, is in any manner affected by the Consensus Rule to the extent that it pertains to deepwater leases. As such, API urges that only the comments of those who have an interest in deepwater production be considered by MMS. *Second*, it is undeniable that substantial costs are incurred by lessees to transport deepwater production to a shelf tie-in. The record indicates that the Committee recognized that, due to the substantial actual costs for transportation incurred by deepwater producers, it would be inequitable to expect them to true-up to a safety net median value reflecting only "shelf to shore" transportation costs. The effect of eliminating the additional location differential adjustment for deepwater leases would be to value deepwater production for royalty purposes at the shelf tie-in, rather than at the lease. API's members strongly oppose, and dispute the legality of, any methodology that would ignore transportation costs in determining royalty value. *Third*, denying deepwater lessees a transportation allowance would result in enormous revenue increases and unjust enrichment of the government at the expense of deepwater lessees.
5. If MMS fails to calculate the safety net in two years, it must keep the states whole, *i.e.*, calculate and pay interest to the states as if additional royalties had been paid. API's comments on Option No. 1, Point Five, are reiterated here. To the extent that no additional royalty is due from lessees as a result of MMS's failure to timely calculate the safety net, API's members have no position on whether the states should be kept whole by MMS.
6. No exception for gross proceeds payors to value small volumes of non-sale (NAL) dispositions on NAL benchmarks rather than index. API disagrees. At the June 12-14, 1996, Committee meeting, the exception was supported by all and added to the "What We Agree On" list.
7. Committee consensus would apply to gathering and transportation. API agrees.

**Montana Proposal**

1. Value royalties on index in accordance with the Consensus Rule, including wellhead MMBtu reporting, but **without** a location differential or transportation allowance. Eliminate the safety net calculation and associated true-up. For the sake of simplicity, API supports elimination of the safety net. The safety net requirement adds unnecessary complexity and uncertainty to the alternative valuation methodology, but API has supported it as part of a total package as a means of addressing MMS concerns about revenue neutrality. API's members strongly oppose any methodology that would ignore transportation costs in determining royalty value. *First*, such a regulation would in effect move the royalty valuation point from its proper place, the lease, to the IPP, which can be located far away. In light of existing precedents, legal challenges would no doubt ensue if such a regulation were promulgated. *Second*, inasmuch as this concept was suggested more than once during the original Committee deliberations and rejected, adopting it in a final rule would require that MMS disregard the Committee consensus. *Third*, this concept is based on an unsupported assumption that federal lessees are realizing "uplift over index" equivalent to their transportation costs. *Minutes, April 25-27, 1994*, at 11. There is no record support for this assumption, and API members disagree with it. *Fourth*, assuming *arguendo* that "uplift equals transportation" for all federal lessees collectively, the same cannot be said for individual lessees. Factors such as distance to IPP vary enormously among lessees and among dispositions. Thus, elimination of the transportation allowance would have a disproportionate impact on individual lessees, depending on their transportation costs, the proportion of "index plus" to "index minus" sales in their portfolios, and a host of other factors. The commerciability of federal leases would be significantly affected. The adverse impacts of such a proposal cannot be over-emphasized.
2. No exception for gross proceeds payors to value small volumes of non-sale (NAL) dispositions on NAL benchmarks rather than index. API disagrees. At the June 12-14, 1996, Committee meeting, the exception was supported by all and added to the "What We Agree On" list.
3. Committee consensus would apply to gathering and transportation. API agrees.

**Unified Industry Proposal No. 1 (Option No. 6)**

Retain the Committee's index-based method but simplify the rule as follows:

1. Write the final rule in plain English.
2. Include a provision for takes basis reporting for 100% Federal agreements and stand-alone leases. Also, an exception would be provided to pay on other methods when all of the parties agree as specified in the Committee Report.
3. For mixed agreements reporting, the exception would be expanded to an average of 500 barrels of oil per month per well or 3,000 MCF per month per well, or combination thereof, determined by dividing the average daily production from all wells on a lease by the number of such wells. For the producer who pays on a takes basis, the time period to reconcile to entitlements would be extended to two (2) years. For adjustments to

entitlement based payments, reciprocal interest would apply to the amount of the adjustment, i.e., the producer pays interest when adjustments are made for undertakes and the MMS pays interest when adjustments are made for overtakes. Interest would not begin to accrue on the adjustment amount until the first month following the two-year period.

4. Delete the second sentence in proposed 30 CFR 202.450(b), which otherwise would deny royalty-free use of gas downstream of the FMP.
5. MMS would issue separate guidance on the reporting of gas valuation consistent with the recommendations of the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting.
6. The Index Pricing Point would be determined by using any single valid publication. The producer would select the single valid publication on a zone-by-zone basis, at the beginning of every year.
7. Index would be applied to the wellhead MMBtu less a location differential to the appropriate Index Pricing Point. There would be no option to value residue gas on index. For split connects or multiple connections the producer would use either a weighted average or an arithmetic average of the published indices from any single valid publication less the applicable location differential. [Refer to the Committee Report, Index Pricing Point (IPP), on page 18, which provides as follows:

   > A single connect is where the IPP is established before the pipeline to which the well, lease, platform central delivery point, or plant (collectively referred to as well) is physically connected, interconnects with other pipelines. For a single connect, the index pricing point will be the first pipeline interconnect for which there is a valid published index.
   >
   > A split connect is defined as more than one pipeline connected directly to the well. A multiple connection is defined as one pipeline connected to the well, but that pipeline splits prior to an index point. (These definitions are illustrated on page 19).
   >
   > To determine the index in the case of split/multiple connects, the lessee has two options:
   >
   > 1. Weighted Average - Calculate the volume weighted average (based on confirmed nominations - either first of the month or total for the month, applied consistently, with no prior period adjustments for allocation or corrections to actual flows) of all the index pricing points to which the well is physically connected, or
   > 2. An arithmetic average of all the physical connections based on the single valid publication.]

8. Gross proceeds payors would have the option for all Federal leases inside or outside an index zone, on an annual basis to elect to apply a gross-proceeds based gas value to the wellhead MMBtu less applicable transportation with no safety net. Producers would still pay on gross proceeds on arm's-length dedicated contracts.
9. For all arm's-length and/or jurisdictional transportation, the location differential would parallel the Index Pricing Point valuation methodology. For transportation that is both non-arm's-length, and non-jurisdictional, the producer would use the Committee's

recommendation. The *de minimis* transportation rate would apply to both gross proceeds and index payors and would not require prior MMS approval.

10. Retain the Committee's recommendations concerning the distinction between transportation and gathering.
11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments but only for the index year for which the safety net is being calculated. The index payors would true up to 75% of the difference between the index payors weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis. Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceed payors.
12. If the safety net is not published within one (1) year following the end of the index year, then no additional royalty would be due and the index would become the final safety net.
13. Any royalties paid for gas contract settlements proceeds would not be considered gross proceeds for safety net calculation purposes.
14. Gross proceeds payors would be allowed to value small volumes of gas sold non arm's-length in accordance with its arm's-length transactions and would not be required to use index pricing.

API strongly supports this proposal. It addresses concerns about the administrative burden of calculating the safety net by relieving MMS of the requirement to audit gross proceeds-based MMS-2014 reports in order to calculate the safety net median value. It addresses the need for simplification by eliminating the option to pay residue on index and liquids on gross proceeds, and by expanding the lessee's ability to report and pay processed gas royalty on a wellhead MMBtu. It addresses the need for a meaningful exception to entitlements reporting on mixed agreements. In order to address concerns about revenue neutrality and to offset any reduction in revenues which may occur as a result of varying from the Consensus Rule, this proposal contains a substantial increase in the safety net cap.

It is important to note that this option contains significant concessions beyond those agreed to by industry representatives in the original regulatory negotiation. These concessions are acceptable to API's members only as part of a whole package containing reciprocal concessions from MMS and the states.

During the June 12-14, 1996, meeting, in response to MMS and state comments on this Unified Industry Proposal, industry representatives offered additional concessions set forth below as Unified Industry Proposal No. 2 (Option No. 7) and Unified Industry Proposal No. 3 (Option No. 8). Either of these two proposals are acceptable to API's members only as part of whole packages containing reciprocal concessions from MMS and the states.

**Unified Industry Proposal No. 2 (Option No. 7)**

Modify Unified Industry Proposal No. 1 as follows:

11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments but only for the index year for which the safety net is being calculated. The index payors would true up to **90%** of the difference between the index payors weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis. Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceed payors.
14. Gross proceeds payors would be allowed to value small **non-arm's-length, non-sale dispositions of royalty-bearing** volumes of gas **(for example, off-lease fuel)** in accordance with its arm's-length transactions and would not be required to use index pricing.

**Unified Industry Proposal No. 3 (Option No. 8)**

Modify Unified Industry Proposal No. 2 as follows:

8. Gross proceeds payors would have the option for all Federal leases inside or outside an index zone, on an annual basis to elect to apply a gross-proceeds based gas value to the wellhead MMBtu less applicable transportation with **a 30% true-up to 101% of** the safety net median value. Producers would still pay on gross proceeds on arm's-length dedicated contracts.
11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments but only for the index year for which the safety net is being calculated. The index payors, would true up to **50% or 65% (as set forth originally in the Committee recommendation)** of the difference between the index payors weighted average index based value and **101% of the safety net median value** for unaudited gross proceeds on a zone-by-zone basis. **(MMS could audit gross proceeds payors, but adjustment reason codes of 40+ would not go into safety net. Adjustments due to exception processing would be included.)** Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceed payors.
12. If the safety net is not published within **two (2) years** following the end of the index year, then no additional royalty would be due and the index would become the final safety net.

**MMS/State Proposal (Option No. 9)**

1. Index/No Location Differential/No Safety Net. This proposal is identical to Point One of the Montana Proposal, discussed *supra*, and API's comments are reiterated here.
2. Determine the IPP using the weighted average method. This proposal is identical to Option No. 3, Point Three, discussed *supra,* and API's objections are reiterated here. As stated before, eliminating the simplification options (fixed index or arithmetic average) in favor of weighted average based on actual flow would increase complexity.
3. The Index Pricing Point would be determined by using any single valid publication. API agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 21.
4. Use the Committee consensus for gathering/compression. API agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list. *Id.*
5. For index payors, allow wellhead MMBtu reporting on processed gas. For the sake of simplicity, API strongly supports this concept.
6. For mixed agreements, producers whose total monthly royalty payments on federal leases total less than $5000.00 qualify to pay on takes. This number was literally picked from thin air. There was no effort to determine that this figure constitutes a meaningful and practical exception to entitlements for small producers. API opposes this provision and supports the exception set forth in the Unified Industry Proposals. Only the Unified Industry Proposals contain a meaningful exception to entitlements. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list. *Id.*
7. No location differential. API opposes and reiterates its response to No. 1 of this proposal, above.

**MMS/State Modified Proposal (Option No. 10)**

1. Index payors would true up to 100% (no safety net cap) of the MMS calculated safety net value. The safety net value would be the weighted average of a stratified sample of arm's-length gross proceeds (including affiliate resale proceeds) accruing to gross proceeds payors and index payors in the zone. The safety net would be published in two years based on audited product codes 03 and 04. API opposes elimination of the safety net caps for the reasons noted in the response to Option No. 3, Point Two, *supra*. API opposes basing the safety net calculation on a weighted average, rather than a median value, for the reasons noted in response to Option 3, Point Four, *supra*. API opposes the stratified sample safety net methodology on several grounds. *First*, and most important, such a method would be virtually impossible to implement. In instances where the stratified sample included sales from pools, MMS would be required to calculate the applicable pool price from hundreds of separate sales and transportation transactions recorded by the lessee or its affiliate. In order to do so, auditors would be forced to extrapolate based on numerous assumptions with which lessees

would likely take issue. Thus, this proposal would increase MMS's administrative burden and the likelihood of technical challenges by many orders of magnitude, compared to a safety net based on MMS-2014 data. *Second*, such a method would give rise to legal disputes regarding gross proceeds, allowable deductions, affiliate resales, etc. The Consensus Rule, Option No. 1, and the Unified Industry Proposals, each substantially avoid these disputes and are therefore far superior to this proposal. *Third*, since the proposed method depends on sampling, MMS's sampling techniques would likely be challenged as statistically unsound. Such a methodology could easily be gamed in such a manner as to consider only the highest priced sales and/or lowest transportation costs. *Fourth*, in light of the many difficulties associated with this methodology, it is unlikely that such a safety net value would ever be calculated and published by MMS on a timely basis.

2. Determine the IPP using the weighted average method. This proposal is identical to Option No. 3, Point Three, discussed *supra,* and API's objections are reiterated here. As stated before, eliminating the simplification options in favor of weighted average based on actual flow would increase complexity
3. The Index Pricing Point would be determined by using any single valid publication. API agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list.
4. Use the Committee consensus for gathering/compression. API agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list.
5. In order to report and pay processed gas royalty on a wellhead MMBtu basis, add 2% to the applicable index or gross proceeds residue price. API's members strongly oppose this proposal. It incorrectly assumes, without evidentiary support, that there is always a 2% uplift in value from processing. More important, the concept of an "Index + X" methodology was considered during the original Committee deliberations and ultimately rejected. The Committee agreed that it would be impossible to determine the value of "X".
6. For mixed agreements, producers whose total monthly royalty payments on federal leases total less than $5000.00 qualify to pay on takes. This number was literally picked from thin air. There was no effort to determine that this figure constitutes a meaningful and practical exception to entitlements for small producers. API opposes this provision and supports the exception set forth in the Unified Industry Proposals. Only the Unified Industry Proposals contain a meaningful exception to entitlements. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list.
7. Arm's-length and jurisdictional transportation allowances should be based on the actual rate paid. Non-arm's-length, non-jurisdictional transportation allowances should be limited to actual costs, or a *de minimis* rate with prior MMS approval. API opposes this concept and recommends the Committee consensus. As general matter, it is recognized that the transportation allowance should be consistent with the IPP selection method. However, because API's members strongly oppose the elimination of the fixed index method without replacing it with another simple method that would not necessitate tracing (*e.g.*, arithmetic average), this proposal is unacceptable. Further, because a simplified IPP selection method

will inevitably include "no flow" situations, transportation allowances cannot be limited to the actual rate paid. The maximum IT rate should be allowed in "no flow" situations. Lessees should be allowed to deduct a *de minimis* rate, subject to audit, without having to secure prior MMS approval, since it is an MMS-calculated rate.

**Conclusion**

API's members cannot support Options Nos. 2, 3, 4, 5, 9, 10, the New Mexico Proposal, or the Montana Proposal. These options share many common characteristics which make them completely unacceptable. *First*, none of such options equitably addresses all of the public comments received on the Consensus Rule. *Second*, although predicated on a need for greater simplicity, each of these options would result in greater complexity and an increased administrative burden, e.g., IPP selection and transportation allowance based on physical flow, safety net calculation based on lessee's own gross proceeds or affiliate's resale, elimination of option for gross proceeds payors to pay gross proceeds residue gas price at wellhead MMBtu, requirement of prior MMS approval to deduct *de miminis* rate. *Third*, these options offer no new solutions but merely reiterate concepts that were previously considered and rejected, e.g., Index+X%, Index with No transportation. In order to implement any of these options, MMS would have to completely disregard the deliberations and the consensus of the Committee. *Fourth*, these options are based on the erroneous assumption that elections enable lessees to minimize their royalty obligation. In fact, numerous safeguards were built into the elections to prevent gaming, e.g., 2-year election on a zone-wide basis. Thus, if any of these options were implemented as a final rule, it would be highly doubtful whether any federal lessee would elect to use the alternative valuation methodology

API supports the Consensus Rule, Option No. 1 (if modified as suggested), or Unified Industry Proposals No. 1, 2 or 3. If modified in accordance the "What We Agree On" list of June 14, 1996, each of these options would substantially address the concerns expressed in the comments on the Consensus Rule without destroying the original Committee consensus. Because of the "higher of" safety net mechanism, the "escape hatch," and the manner in which index prices are based on third party sales, adopting an alternative valuation methodology consistent with these options exposes MMS to little downside risk of changes in the gas market. Each of these options would enable MMS to disgard the alternative valuation methodology without further rulemaking if index prices were no longer valid in a zone. Therefore, API exhorts MMS to proceed with publishing a final rule consistent with these options as expeditiously as possible, delaying the effective date no longer than six months after publication.

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